

**STATE OF ALABAMA**  
**DEPARTMENT OF INSURANCE**  
**MONTGOMERY, ALABAMA**

**REPORT ON EXAMINATION**

as of

**DECEMBER 31, 2001**

of

**ALFA INSURANCE CORPORATION**

**MONTGOMERY, ALABAMA**

**PARTICIPATION:**

**Alabama**

**EXAMINATION AFFIDAVIT**

**STATE OF ALABAMA  
COUNTY OF MONTGOMERY**

Rex H. Newborn being first duly sworn, upon his oath deposes and says:

That he is an examiner appointed by the Commissioner of Insurance for the State of Alabama;


That an examination was made of the affairs and financial condition of Alfa Insurance Corporation for the period of January 1, 1998 through December 31, 2001;

That the following 30 pages constitute the report thereon to the Commissioner of Insurance of the State of Alabama;

And, that the statements, exhibits, and data therein contained are true and correct to the best of his knowledge and belief.

  
\_\_\_\_\_  
Rex H. Newborn  
Examiner-in-charge

Subscribed and sworn to before the undersigned authority this 16<sup>th</sup> day of July 2004.

  
\_\_\_\_\_  
(Signature of Notary Public)

Debra L. Meadors, Notary Public  
Printed name

in and for the State of Alabama

My commission expires 7/22/2006

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Montgomery, Alabama  
February 20, 2004

Honorable Jose Montemayor  
Chairman, Examination Oversight Task Force  
Texas Department of Insurance  
P.O. Box 149104  
Austin, TX 78714-9104

Honorable Alfred W. Gross  
Secretary Southeastern Zone  
Virginia Bureau of Insurance  
P.O. Box 1157  
Richmond, Virginia 23218

Honorable Walter A. Bell  
Commissioner of Insurance  
Alabama Department of Insurance  
Post Office Box 303350  
Montgomery, Alabama 36130-3350

Dear Commissioner Bell:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions adopted by the National Association of Insurance Commissioners, an examination has been made of the affairs and condition of

**Alfa Insurance Corporation  
Montgomery, Alabama**

as of December 31, 2001, at its home office located at 2108 East South Boulevard, Montgomery, Alabama 36116. The report of examination is submitted herewith.

Where the term, Company, appears herein without qualification, it is synonymous with Alfa Insurance Corporation.

## **SCOPE OF EXAMINATION**

The examination reported herein covers the period from December 31, 1997 through December 31, 2001, and has been conducted by examiners representing the Alabama Department of Insurance. The Company's insurance affiliates (five property and casualty companies, and one life insurance company) have been examined concurrently with the examination of the Company. Events subsequent to December 31, 2001, have been reviewed as required and are reported herein as deemed appropriate.

The Company has been examined in accordance with the statutory requirements of the Alabama Insurance Code and the regulations and bulletins of the Alabama Department of Insurance; in accordance with the applicable guidelines and procedures of the NAIC; and in accordance with generally accepted examination standards.

The examination included a general review of the Company's operations, administrative practices and compliance with statutes and regulations. Income and disbursement items were tested for selected periods. Assets were verified and valued and all known liabilities were established or estimated as of December 31, 2001, as shown in the financial statements contained herein.

In compliance with requirements of the Alabama Department of Insurance, the President and Treasurer of the Company executed a letter of representation certifying that the Company had valid title to all its reported assets, and that it did not have unreported liabilities as of December 31, 2001.

Within this report, discussion of the Company's accounts has been confined to those items for which a material change in the financial statements has been noted or for which comments and/or recommendations have been made.

## **ORGANIZATION AND HISTORY**

The Company was incorporated March 11, 1955, as a mutual insurance company, under the name, American Service Mutual Insurance Company.

In December of 1977, Alabama Farm Bureau Mutual Casualty Insurance Company, (currently Alfa Mutual Insurance Company (AMI)) obtained control of the Company pursuant to an agreement whereby AMI acquired the Company's outstanding surplus notes, all directors of the Company resigned, and new directors designated by AMI were elected.

Effective August 31, 1982, the Company was converted to a stock insurance company. Its certificate of authority was amended to authorize 3,000,000 shares of common stock

at a par value of \$1.00 per share. The initial capitalization was effected by the sale of 500,000 shares of its common stock for \$2.50 per share, to Federated Guaranty Life Insurance Company (currently Alfa Life Insurance Corporation (ALI)). The sale resulted in \$500,000 of paid up capital and \$746,683 of paid in surplus (\$3,317 was expended in costs of asset transfers). The name of the Company was changed to Federated Guaranty Insurance Company.

On January 4, 1983, the holding company now named Alfa Corporation was incorporated in Delaware under the name, Federated Guaranty Corporation. At that time the stock of the Company, as well as that of its parent, ALI, was contributed to Alfa Corporation.

Effective May 1, 1987, the Alabama Farm Bureau Federation withdrew from the national Farm Bureau Federation, of which it was a franchise member, and changed its name to Alabama Farmers Federation. The name of the Company was changed to Alfa Insurance Corporation.

During the interim from the Company's organization through 1987, the Company became affiliated with four other property and casualty insurers. In 1987 a reinsurance pooling agreement was formed between these five affiliates. The terms of the agreement provide that all direct business of the affiliates will be ceded to AMI. The pooled business is then retroceded according to percentages provided in the pooling agreement. In 1989 an intercompany reinsurance pooling committee, representing the boards of directors of the reinsurance pool participants, was established. This committee is responsible for reviewing and approving any changes to the pooling agreement, to assure that transactions are fair and equitable to all pool participants, and to monitor potential, or actual, conflicts of interest between pool participants.

In 1999, Alfa Specialty Insurance Corporation (ASI) was organized as a stock company, wholly-owned by AMI. ASI became a participant in the reinsurance pooling agreement in 2001.

Numerous increases were made to the Company's capital structure between 1982 and 1994. The last such change occurred on December 31, 1994. Paid up capital was increased to \$1,500,000, consisting of 1,500,000 shares of \$1.00 par value common stock issued and outstanding. Paid in surplus amounted to \$30,673,465 at that date. There have been no further changes in the Company's capital structure through the date of this examination.

## **GROWTH OF THE COMPANY**

The following schedule presents financial data, which reflect the growth of the Company for the years indicated:

<u>Year</u>	<u>Gross Premiums Written</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Policyholders' Surplus</u>
1997	213,783,382	218,782,872	131,842,597	86,940,275
1998	225,635,502	230,950,109	132,574,420	98,375,688
1999	235,311,375	256,170,195	141,635,995	114,534,200
2000	248,015,773	270,414,353	152,474,444	117,939,909
2001	265,260,944	291,199,950	155,813,328	135,386,622

Data for the years 1997 and 2001 are per examination. Data for the remaining years were obtained from the Company's Annual Statements.

## **TERRITORY**

As of December 31, 2001, the Company was licensed to transact insurance business in the following jurisdictions:

Alabama	Florida	Georgia
Indiana	Louisiana	Mississippi
Nebraska	New Mexico	Oklahoma
Tennessee	Texas	Washington
Wyoming		

The Certificates of Authority from the respective jurisdictions were inspected and found to be in effect at December 31, 2001.

## **STATUTORY DEPOSITS**

In compliance with statutory requirements for transacting insurance business in the respective jurisdictions, the Company had the following securities on deposit at December 31, 2001:



Deposits Held for the Benefit of Policyholders, Claimants, and Creditors of the Company

	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
<u>Alabama</u>			
Compass Bank, U.S. Treasury Note, 7.625%, due 2/15/07	\$300,000	\$298,884	\$ 301,875
<u>Louisiana</u>			
Bank One of Louisiana, U.S. Treasury Note, 7.625%, due 2/15/07	25,000	24,646	25,156
<u>New Mexico</u>			
Bank of Santa Fe, U.S. Treasury Note, 7.625%, due 2/15/07	200,000	197,167	201,250
<u>Florida</u>			
First Union Bank, U.S. Treasury Note, 8.00%, due 11/15/21	325,000	341,391	411,226
<u>Georgia</u>			
Wachovia Bank, U.S. Treasury Note, 7.625%, due 2/15/07	<u>85,000</u>	<u>84,861</u>	<u>85,531</u>
Totals	<u>\$935,000</u>	<u>\$946,949</u>	<u>\$1,025,038</u>

All statutory deposits were confirmed as of December 31, 2001, by written correspondence with the respective custodians.

**HOLDING COMPANY AND AFFILIATES**

**Holding Company Registration and Reporting**

The Company is deemed to be subject to the Alabama Insurance Holding Company Regulatory Act of 1973, as defined in Section 27-29-1, *Code of Alabama*, 1975. The Company is responsible for holding company registration and periodic informational filings with the Alabama Department of Insurance, in accordance with Section 27-29-4, *Code of Alabama*, 1975, and Alabama Department of Insurance *Regulation Number 55*.

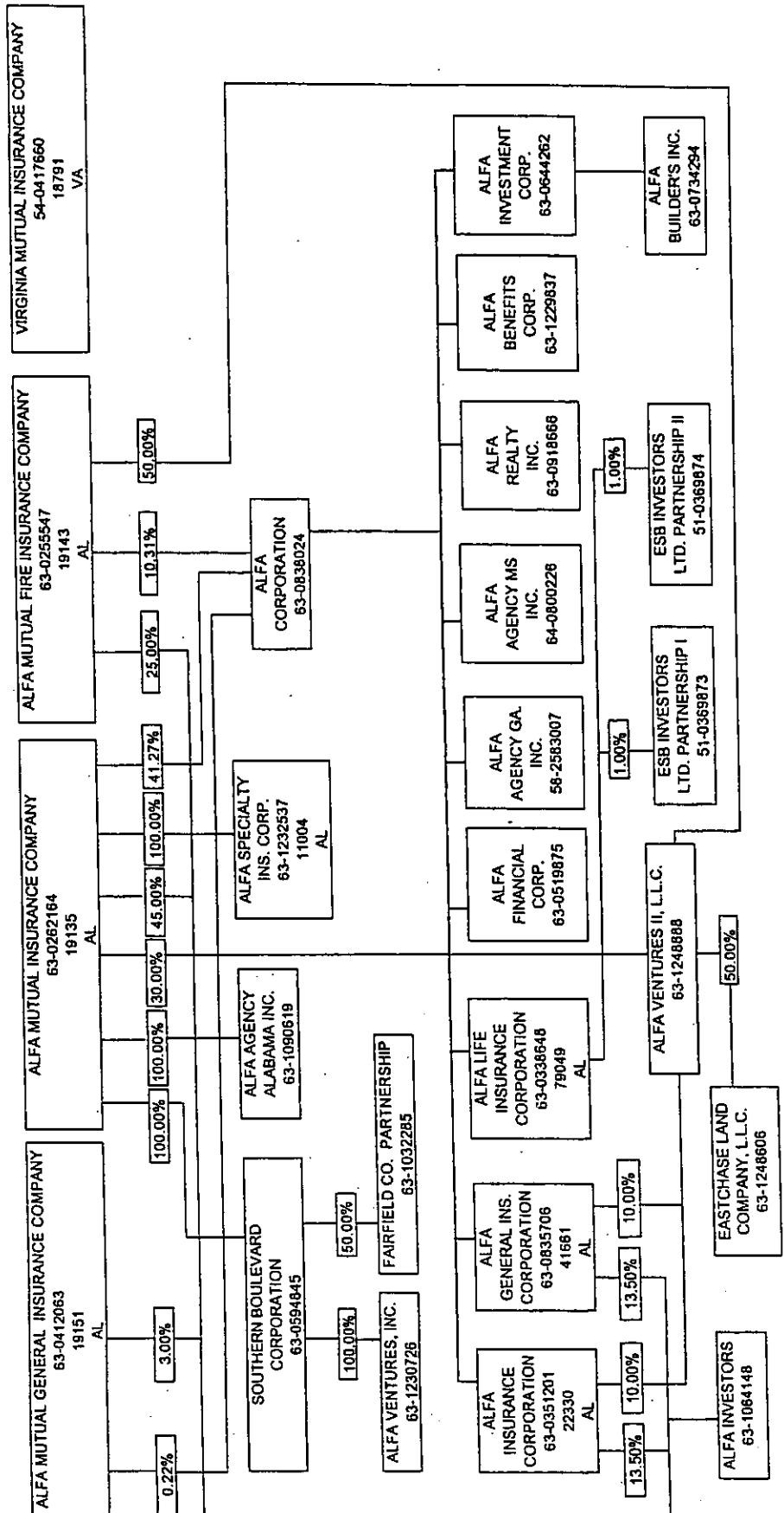
Holding Company filings and amendments to registration statements made on behalf of the Company and its affiliates, for the years under examination, were reviewed. Said

filings and amendments were found to be substantially complete and to reflect the required disclosures.

### **Organization Chart**

The chart on the following page depicts the insurance holding company system with which the Company was affiliated as of December 31, 2001.

# ORGANIZATIONAL CHART



## **Agreements with Affiliates**

### **Management and Operating Agreement:**

The following insurers were under the control of Alfa Mutual Insurance Company (AMI) and were parties to a Management and Operating Agreement with AMI: the Company; Alfa Mutual Fire Insurance Company; Alfa Mutual General Insurance Company; Alfa General Insurance Corporation; Alfa Specialty Insurance Corporation; and, Alfa Life Insurance Corporation. These companies will be referred to, collectively, as the "affiliates" in the remainder of the discussion of this topic.

This agreement has been in effect since January 1, 1960, with periodic amendments to modify the terms and to add companies as they became affiliated. Effective January 1, 1990, it was revised to continue on an annual basis through December 31, 2001. After that date, the agreement has been extended for additional periods of one year each.

Pertinent terms of the agreement include the following:

- 1) The affiliates designate AMI to take charge of, conduct, operate and manage the business of the affiliates, respective to each affiliate's charter and Board of Directors, and in a manner conducive to the profitable operation of each respective affiliate. AMI will provide all home office operating services to the affiliates, including accounting, disbursement and payroll services and will serve as a disbursing agent for the payment of all employees and agents of the affiliates.
- 2) AMI agrees to employ, in its own name, all personnel necessary to perform the aforesaid, and reserves all rights and responsibilities of the employer of said personnel. All agents of the affiliates shall be appointed in the name of the respective affiliates and shall work on behalf of the respective affiliates. All personnel and agents of any affiliate employed outside Alabama are the sole responsibility of that affiliate. AMI also agrees to indemnify and hold the affiliates harmless against any loss on account of the dishonesty or infidelity of any AMI employees.
- 3) AMI agrees that the business of each party to the agreement shall be conducted in the name of the respective party and that the records of each party shall be kept separately. AMI Company agrees to provide all required records, record-keeping services and data processing necessary to the efficient and economical operation of such business.
- 4) The affiliates agree to reimburse AMI for expenses and additional charges in accordance with schedules which are attached to the agreement. These schedules are subject to periodic amendment. Expense allocations and

other charges are determined by time, usage, and related special expense allocation studies conducted by AMI. Expenses entirely attributable to the affiliates such as printing and supplies are purchased and paid for directly by the respective affiliate.

Numerous expense categories are prorated between affiliates on Schedule A, an attachment to the agreement. Certain other expenses are allocated directly to the affiliates that benefit from expenditures. Agent's commissions are allocated 100% to the affiliate writing the business. Fixed monthly charges are paid by the affiliate for certain other expenses.

#### Tax Allocation Agreement

The Company and certain of its affiliates filed consolidated federal income tax returns during the examination period. The terms of the agreement for allocation of taxes are related in a resolution by the board of directors of the companies that are subject to the agreement. However, no formalized tax allocation agreement among the affiliates has been reduced to writing. Furthermore, the board resolutions do not discuss the settlement of balances between companies. SSAP No. 10, Section 12 c. requires a written income tax allocation agreement, which specifies the terms for settlement of intercompany balances, for recognition of consolidated income tax filings among affiliates.

#### Dividends to Stockholders

During the period under examination, the Company paid the following cash dividends to its sole stockholder, Alfa Corporation.

<u>Year</u>	<u>Dividend</u>
1997	\$ 6,319,500
1998	\$ 6,867,000
1999	\$ 7,231,500
2000	\$18,067,500
2001	\$ 7,908,000

Dividends paid appeared to be in accordance with Alabama statutes and regulations.

## **CORPORATE RECORDS**

The Company's Articles of Incorporation, By-Laws and amendments thereto were inspected and found to provide for operation of the Company in accordance with Alabama statutes and regulations and with accepted corporate practices.

Minutes of the meetings of the stockholders, board of directors and committees of the Company, from December 31, 1997 through the most recent meetings recorded at the time of examination, were reviewed. The minutes appeared to be complete and to adequately document the actions of the respective governing bodies.

## **MANAGEMENT AND CONTROL**

### **Stockholders**

The sole stockholder of the Company is Alfa Corporation, a Delaware corporation. Controlling interest in Alfa Corporation (51.8% at December 31, 2001) was held by the three Alfa mutual insurance companies: Alfa Mutual Insurance Company 41.27%; Alfa Fire Insurance Company 10.31%; and Alfa Mutual General Insurance Company .22%. The remaining 48.2% of the stock was publicly held.

### **Board of Directors**

The Company's By-Laws provide that its property and business shall be managed by a board of directors consisting of eight (8) persons, at least one-third of whom shall be residents of Alabama. Directors are elected at the annual meeting of the stockholder and serve until their successors are elected and qualified.

The following directors were elected by the stockholder and were serving at December 31, 2001:

Director/Residence  
Jerry Allen Newby  
Athens, Alabama

Principal Occupation  
Chairman of the Board, CEO,  
and President, Company

Stephen Leonard Dunn  
Evergreen, Alabama

Treasurer, Alfa Mutual Companies

(continued next page)

Director/Residence

Principal Occupation

Hal Franklin Lee  
Hartselle, Alabama

Vice President (North Area), Alfa Mutual  
Companies

Benjamin Phil Richardson  
Montgomery, Alabama

Retired, Company Executive Vice President

John Russell Thomas  
Alex City, Alabama

President, Aliant National Corporation

James Albert Tolar, Jr.  
Marion, Alabama

Vice President (Southwest Area), Alfa Mutual  
Insurance Company

Russell Riley Wiggins  
Andalusia, Alabama

Vice President (Southeast Area), Alfa Mutual  
Insurance Company

Curtis Dean Wysner  
Woodland, Alabama

Vice President (Central Area), Alfa Mutual  
Insurance Company

Officers

The Company's By-Laws provide that its principal officers shall be a chairman of the board, a president, one or more vice presidents, a secretary, a treasurer, and such other officers as the board of directors may determine, and for such terms, authority and duties as may be determined by the appointment. Any two or more offices may be held by the same person, except the offices of president and secretary. Unless otherwise designated, the President will be the CEO.

The following officers were elected by the Board of Directors and were serving at December 31, 2001:

Jerry Allen Newby  
Clyde Lee Ellis III  
Herman Alan Scott

Chairman of the Board, President, and CEO  
Vice President and Treasurer  
Secretary

The following officers were appointed by the stockholder and were serving at December 31, 2001:

Clyde Lee Ellis III  
Charles Wayne Hawkins

Executive Vice President, Operations  
Executive Vice President, Marketing

(continued next page)

Stephen Goddard Rutledge  
 Herman Alan Scott  
 Jimmy Rogers Azar  
 John Thomas Jung  
 James Terry McCollum  
 Thomas Earle Bryant  
 Wyman Cabaniss  
 Carol Lynn Golsan  
 Darrell Lee McNeal  
 Robert Wyatt Pace  
 Linda Gail Harwell  
 Kenneth Everette Stephens  
 Elizabeth Vail Chancey  
 John Daryl Holley  
 David Ray Proctor  
 Don Eugene Manis  
 Joanne Wilson  
 Christine Gnann Cantrell  
 Kevin Lee Ketzler  
 Alfred Edwin Schellhorn  
 Connie Leah Whitecotton  
 Patti Jo Everage  
 Michael Edward Epton  
 Jacob Daniel Black

Senior Vice President, CFO & CIO  
 Senior Vice President and General Counsel  
 Senior Vice President, IA and Planning  
 Senior Vice President, CIO  
 Senior Vice President, Claims  
 Senior Vice President, Human Resources  
 Senior Vice President, P&C Underwriting  
 Vice President, Marketing Services  
 Vice President, Georgia Marketing  
 Vice President, Mississippi Marketing  
 Vice President, Auto Underwriting  
 Vice President, P&C Systems Implementation  
 Vice President, P&C Underwriting  
 Vice President and Assistant CFO  
 Vice President, Taxes  
 Vice President, Property Actuary  
 Vice President, Professional Development  
 Vice President, Marketing Communications  
 Vice President, Real Estate  
 Vice President, Mergers & Acquisitions  
 Assistant Vice President, Internal Audit  
 Assistant Vice President, Finance  
 Assistant Vice President, Finance  
 Assistant Vice President, Finance

### **Committees**

The following committees were appointed by the board of directors and were serving at December 31, 2001:

Contributions Committee	James Albert Tolar, Jr., Chairman Stephen Leonard Dunn Curtis Dean Wysner
Pooling Committee	Jerry Allen Newby Benjamin Phil Richardson John Russell Thomas

### **Conflict of Interest**

Conflict of interest statements executed during the examination period were reviewed through 1999. The Company's Policy Statement on Business Ethics and Conflicts of



Interest, in effect prior to 2001, required all directors, officers, and employees to execute conflict of interest statements annually. Effective July 18, 2001, the Company adopted a new "Principles of Business Conduct." Because the drafting and adoption of this new policy was in process, there were no conflict of interest statements executed for the year 2000.

The new policy does not require annual conflict of interest statements. It has been amended, February 4, 2003, to incorporate the provisions required by the Federal Sarbanes-Oxley Act. Under the policy, all new employees are required to confirm their compliance with the policy at their hiring. Confirmations are obtained from all existing employees when the policy undergoes significant revision, or whenever circumstances dictate that reconfirmation would be helpful in reinforcing the Company's "tone at the top" message.

### **FIDELITY BOND AND OTHER INSURANCE**

The Company and its affiliates were covered by a fidelity bond through the Fidelity and Deposit Company of Maryland, at December 31, 2001. This policy provided for maximum coverage of \$2,000,000, which was in excess of the \$1,000,000 amount recommended by NAIC guidelines. Nevertheless, the policy covered twenty-two named insureds which were also affiliates of the Company. The application of the NAIC guidelines based on the assets and income of the Company alone is deemed not to provide an adequate amount of fidelity bond coverage for all the named insureds.

It was deemed to be beyond the scope of the examination to attempt to a consolidation of the assets and income of the subject affiliates in order to arrive at an adequate amount of fidelity bond. The Company has agreed to compute the required amount of fidelity bond, based on a consolidation, and to increase its coverage accordingly.

In addition to the above, the Company had the following coverages in effect at December 31, 2001, under policies issued directly to the Company or as a named insured under policies issued to an affiliate.

- Professional Liability
- Boiler and Machinery
- Commercial Property
- General Liability
- Inland Marine
- Commercial Umbrella
- Worker's Compensation and Employer's Liability
- Business Automobile Insurance

The coverages and limits of the Company's insurance were reviewed and were deemed to adequately protect the Company's interest.

### **EMPLOYEE AND AGENTS' WELFARE**

The Company had no employees of its own during the examination period. Its operations are conducted by personnel employed by Alfa Mutual Insurance Company (AMI), under a management agreement that has been in effect since 1982. All employee and agents benefits for the Alfa Insurance Group are administered by AMI. Costs are allocated to the individual affiliates in accordance with the terms of the agreement.

### **REINSURANCE**

#### **Intercompany Reinsurance Pooling Agreement**

This agreement was effective August 1, 1987, between the Company and its affiliates: Alfa Mutual Insurance Company; Alfa Mutual Fire Insurance Company; Alfa Mutual General Insurance Company; and, Alfa General Insurance Corporation. Alfa Specialty Insurance Corporation, incorporated in 1999, was added to the pool in 2001. These participants in the pooling agreement will be referred to as "the affiliates" for the remainder of this discussion. This reinsurance pooling agreement was filed with the Alabama Department of Insurance on July 29, 1987, and was subsequently approved. Pertinent terms of the agreement are as follows:

Initially, the affiliates ceded 100% of their book of business then in force to Alfa Mutual Insurance Company (AMI) and paid AMI their proportionate share of the net unearned premium less commissions at the provisional rate of 20%.

Currently, the affiliates cede 100% of the net liabilities for net premiums written to AMI and AMI retains or retrocedes the Pooled business in accordance with the following percentages:

(continued next page)

	08/01/87	10/01/94	10/01/96	01/01/01
Company	Pool 1	Pool 2	Pool 3	Pool 4
AMI	32.0	24.0	32.0	18.0
AMF	15.0	8.0	0.0	13.0
AMG	3.0	3.0	3.0	3.0
AGI	25.0	32.5	32.5	32.5
AIC	25.0	32.5	32.5	32.5
ASI (joined pool in 2001)				1.0

Effective November 1, 1996, the affiliates amended the agreement to include catastrophe coverage. The following percentages are shown below for the Coinsurance Allocations for Catastrophe Losses and Related Expenses for the related years:

Effective November 1, 1996			Effective July 1, 1999			Effective January 1, 2001		
Cumulative Calendar Year Catastrophe Losses and Related Expenses	Coinsurance Allocation		Cumulative Calendar Year Catastrophe Losses and Related Expenses	Coinsurance Allocation		Cumulative Calendar Year Catastrophe Losses and Related Expenses	Coinsurance Allocation	
	AGI	AMI AMG		AGI	AMI AMG		AGI AIC	AMI, AMF, AMG, ASI
10	65%	35%	11	65%	35%	11.4	65%	35%
19	0	100%	19	0	100%	19	0	100%
32	0	100%	32	0	100%	32	0	100%
43	0	100%	43	0	100%	43	0	100%
77	0	100%	77	0	100%	77	0	100%
146	0	100%	146	0	100%	146	0	100%
198	0	100%	198	0	100%	198	0	100%
249	13%	87%	249	13%	87%	284	14%	86%
325	13%	87%	325	13%	87%	325	14%	86%
353+	13%	87%	353+	13%	87%	353+	14%	86%

- Cumulative calendar year catastrophe losses and related expenses are in millions.
- AIC and AGI to be allocated equally.
- AMI, AMF, AMG, and ASI to be allocated according to this group's relative pool percentages in effect.
- Catastrophe losses are to be accumulated during each annual calendar period.

### **Reinsurance Assumed**

The only reinsurance assumed by the Company during the examination period, other than through the intercompany reinsurance pool, was reinsurance assumed from the following mandatory pools: Georgia Underwriting Association; Georgia Worker's Compensation; Mississippi Underwriting Association; and, Mississippi Worker's Compensation. At December 31, 2001, the Company's liabilities that resulted from participation in these pools were insignificant in amount.

## **Reinsurance Ceded**

As of December 31, 2001, the following contracts for ceding reinsurance were applicable to the Company:

General Reinsurance Corporation - contracts are as follows:

- Excess of Loss Reinsurance- effective January 1, 1998, on property business. The Company's retention for the first excess cover was \$500,000 and the second excess cover is \$1,000,000. The limit of liability of the reinsurer will not exceed a total payment of net loss and adjustment expense combined under the first excess cover of \$1,500,000 or under the second excess of \$3,000,000 all risks involved in one occurrence. This agreement also includes excess of loss reinsurance of liability business and insurance agents' errors and omissions business. The Company's retention is \$500,000 for the first excess cover and the second excess cover is the difference between \$2,000,000 and the sum of the indexed company retention and the first excess cover.
- Quota Share and Excess of Loss Reinsurance of Personal Umbrella Business - effective July 1, 1998, on automobile liability, licensed recreational vehicles, uninsured/underinsured motorists coverages, business pursuits, employers liability, personal liability and unlicensed recreational vehicles, and watercraft liability. In determining the Company's retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence.
- Quota Share and Excess of Loss Reinsurance of Farm Personal Umbrella Business - effective July 1, 1998, on automobile liability, licensed recreational vehicles, uninsured/underinsured motorists coverages, business pursuits, employers liability, farm liability, personal liability and unlicensed recreational vehicles, and watercraft liability. In determining the Company's retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence.
- Quota Share and Excess of Loss Reinsurance of Commercial Umbrella Business - effective July 1, 1998, on commercial general liability, comprehensive automobile liability including hired and non-owned auto coverage and uninsured/underinsured motorists coverages, comprehensive automobile liability for school/church buses, watercraft liability, employers' liability, and professional liability. In determining the Company retention and limit of liability of the reinsurer, the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence/ \$5,000,000 aggregate (where applicable).
- Quota Share and Excess of Loss Reinsurance of Commercial Umbrella Business produced by American Direct - effective July 1, 1998, on commercial general liability, comprehensive automobile liability including hired and non-owned auto coverage and uninsured/underinsured motorists coverages, comprehensive automobile liability of school/church buses, watercraft liability, employer' liability, and professional liability. In determining the Company retention and limit of liability of the reinsurer,

the limit of liability of the Company with respect to any one policy shall be deemed not to exceed \$5,000,000 each occurrence/ \$5,000,000 aggregate (where applicable).

Catastrophe Limited & Lloyd's of London - The contracts were terminated for new business in 1995. An immaterial amount of run-off business remained at December 31, 2001.

All the contracts for ceded reinsurance contain the usual insolvency clause, which provides for payments to a receiver or statutory in the event of the insolvency of the ceding company.

## **MARKET CONDUCT**

### **Plan of Operation**

Direct writing operations of the Company were confined to the States of Georgia and Mississippi, during the examination period. At December 31, 2001, the Company's agency force consisted of 124 captive agents, operating from 63 service centers in Georgia and 62 service centers in Mississippi.

For the year 2001, about 75% of the direct business written by the Company was comprised of private passenger automobile insurance. Homeowner insurance comprised another 19% of the Company's direct business. The remaining 6% was comprised mostly commercial multiple peril, with small amount of fire, allied lines, inland marine and other liability.

The Company did not disclose any plans for acquisitions or expansion in the future.

### **Policy Forms and Underwriting**

All the Company's active policy forms and rates in force at December 31, 2001 were found to have been approved by the Alabama Department of Insurance. Rates were filed independently on the Company's direct business.

### **Compliance With Agents Licensing Requirements**

In order to verify compliance with agents licensing requirements of the Alabama Department of Insurance (ALDOI), a sample of the Company's commission payments

was checked against the licensing records of the ALDOI. No discrepancies were found in the sample.

### **Advertising**

The Company's advertising was planned and coordinated by Creative Consultants, Inc, a wholly-owned subsidiary of the Alabama Farmers Federation. The cost of advertising was shared on a proportionate basis with other participating affiliates of the Company and the Alabama Farmers Federation. Various types of advertising were utilized, such as, signs, billboards, newspaper advertisements and spot advertisements on radio and television. The Company also has a Web page ([www.alfains.com](http://www.alfains.com)), which displays the following links: Company's background, product lines, employment opportunities, agent access, how to locate an agent or the Farmers Federation and investing in Alfa stock. The Company also maintained a cooperative advertising program with its agents. Company sponsored advertising materials were made available to the agents for their advertising purposes. Advertisement costs were shared on a 50/50 basis with the agents when the advertising was approved by the Company and paid invoices were submitted by the agent.

### **Claims Payments Practices**

A random sample of open, closed and closed without payment claim files was reviewed in order to evaluate the Company's claims payment practices. Claims sampled were reviewed with regard to compliance with policy provisions, timeliness of payments, and adequacy of documentation. No noteworthy discrepancies were found within the sample of claims that was reviewed. However, the Company could not produce five of the forty-seven claim files that were selected. This is deemed to be a violation of Section 27-27-29(a), *Code of Alabama*, 1975, which requires insurers to keep complete and accurate records in its home office.

### **Complaints**

The files of the Alabama Department of Insurance (ALDOI) were reviewed for complaints against the Company. The overall number of complaints during the examination period was deemed to be low in relation to the amount of the Company's business. However, the Company did not maintain a record of those complaints that were made directly to the Company and not reported to regulatory agencies.

The NAIC Market Conduct Handbook stipulates that a complaint register should include consumer direct complaints as well as those complaints filed with regulatory authorities.

## **Privacy**

The Company's policy is that non-public information involving underwriting, marketing, claims handling and fraud prevention is not shared with anyone outside the Company except for that sharing allowed by the exceptions in the Gramm-Leach-Bliley Act (GLBA). The insured receives a Privacy Notice at the point of sale and the Company sends a Privacy Notice to the insured on an annual basis. The Company appeared to be in compliance with the privacy requirements of Alabama Department of Insurance, *Regulation No. 122*.

## **ACCOUNTS AND RECORDS**

### **Internal Accounting Records**

The Company's internal controls and information systems are those of Alfa Mutual Insurance Company (AMI), since the Company is operated by AMI, in accordance with a "Management and Operating Agreement," among AMI and its affiliates. See "Holding Company and Affiliates," subsection, "Agreements with Affiliates" for details of the agreement. Said internal controls and information systems were reviewed during the concurrent examination of AMI. They appeared to be sufficient to safeguard Company assets and to generate adequate records of its business. The Company's accounting systems and documentation of its transactions were deemed to be adequate.

AMI's internal audit department reports to management, rather than to the Audit Committee of the Board of Directors. Most of the reports generated by internal audit were concerned with agency transactions and service center accounting. Internal audit reports were made available to the examiners, but were of limited use for examination purposes.

### **External Audit and Actuarial**

The Company and its affiliates were audited, on a statutory basis, for each of the years under examination by the certified public accounting firm of KPMG, LLP. The audit reports and work papers of the external auditors were made available to the examiners, and have been utilized in the examination to the extent deemed appropriate.

The Company's reserves were certified, as of December 31, 2001, by Scott Weinstein, FCAS, MAAA of KPMG LLP, of Atlanta, Georgia.

## **FINANCIAL STATEMENTS**

Financial statements included in this report, which reflect the operations of the Company for the years under examination and financial condition at December 31, 2001, consist of the following:

	<u>Page</u>
Statement of Assets, Liabilities, Surplus and Other Funds . . . . .	21
Statement of Income . . . . .	23
Reconciliation of Surplus as Regards Policyholders . . . . .	24

***THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS ARE  
AN INTEGRAL PART THEREOF.***



# STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS

For the Period Ended December 31, 2001

## ASSETS

	<u>Assets</u>	<u>Non-Admitted Assets</u>	<u>Admitted Assets</u>
Bonds	\$ 209,730,748		\$ 209,730,748
Preferred stocks	2,194,000		2,194,000
Common stocks	12,214,973		12,214,973
Cash	1,159,629		1,159,629
Short-term investments	19,822,665		19,822,665
Other invested assets	17,274,659		17,274,659
Receivable for securities	797,089		797,089
Installment premium plan	14,956,371		14,956,371
Agents balances or uncollected premiums:			
In course of collection	428,374	\$ 14,527	413,847
Installments booked but deferred	124,638	12,464	112,174
Funds held by reinsured companies	51,972		51,972
Reinsurance recoverable	6,232	324	5,908
Federal income tax recoverable	5,855,125		5,855,125
Guaranty funds receivable	358,746		358,746
Data processing equipment	11,189	11,189	
Interest, dividends and real estate income	3,019,653		3,019,653
Receivable from affiliates	3,217,466		3,217,466
Other assets nonadmitted	25,000	25,000	
Accounts receivable	1,842		1,842
Commercial audit premiums	60,678	47,595	13,083
Prepaid expenses	130,278	130,278	
Total Assets	<u>\$ 291,441,327</u>	<u>\$ 241,377</u>	<u>\$ 291,199,950</u>

## STATEMENT OF ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS (continued)

### LIABILITIES SURPLUS AND OTHER FUNDS

#### Liabilities

Losses ( <b>Note - 1</b> )	\$ 53,690,000
Loss adjustment expenses ( <b>Note -1</b> )	9,346,000
Other expenses	5,018,658
Taxes, licenses and fees	536,470
Unearned premiums	56,833,911
Funds held by Company under reinsurance treaties	6,916
Amounts withheld or retained for account of others	4,736,310
Provision for reinsurance	1,204
Drafts outstanding	2,845,164
Payable to affiliates	1,771,203
Payable for securities	2,565,269
Option liabilities	16,100
Reserve for premium deficiency ( <b>Note - 2</b> )	376,734
Reserve for advance premium	11,981,602
Rounding	<u>2</u>
Total liabilities	\$ 149,725,543

#### Surplus and Other Funds

Partnership capital commitment - special surplus	\$ 7,386,277
Common capital stock	1,500,000
Gross paid in and contributed surplus	30,673,466
Unassigned funds (surplus) ( <b>Note -3</b> )	<u>101,914,664</u>
Surplus as regards policyholders	<u>141,474,407</u>
Total liabilities, surplus and other funds	<u>\$ 291,199,950</u>

# STATEMENT OF INCOME

For the Periods Ended,

	December 31, 2001	December 31, 2000	December 31, 1999	December 31, 1998
Underwriting income:				
Premiums earned	\$ 196,294,695	\$ 186,111,909	\$ 176,569,291	\$ 170,883,773
Deductions:				
Losses incurred (Note - 1)	\$ 120,676,170	\$ 116,488,404	\$ 107,840,046	\$ 109,133,446
Loss expenses incurred (Note - 1)	3,072,650	8,925,075	8,508,236	8,594,692
Other underwriting expenses incurred	53,390,020	46,933,920	42,888,853	39,390,854
Change in premium deficiency	224,775			
Total deductions	\$ 177,363,615	\$ 172,347,399	\$ 159,237,135	\$ 157,118,992
Net underwriting gain (loss)	\$ 18,931,080	\$ 13,764,510	\$ 17,332,156	\$ 13,764,781
Investment income:				
Net investment income earned	\$ 14,094,614	\$ 14,660,877	\$ 13,743,529	\$ 12,961,494
Net realized capital gains (losses)	(637,427)	177,646	795,734	1,071,772
Net investment gain (loss)	\$ 13,457,187	\$ 14,838,523	\$ 14,539,263	\$ 14,033,266
Other income:				
Finance and service charges not included in premiums	\$ 2,639,358	\$ 2,389,029	\$ 1,954,133	\$ 2,017,838
Miscellaneous income			715,000	-
Total other income	\$ 2,639,358	\$ 2,389,029	\$ 2,669,133	\$ 2,017,838
Net income before dividends and taxes	\$ 35,027,625	\$ 30,992,062	\$ 34,540,552	\$ 29,815,885
Federal income taxes incurred	7,571,304	8,744,237	10,098,798	9,597,261
Net income	\$ 27,456,321	\$ 22,247,825	\$ 24,441,754	\$ 20,218,624

# RECONCILIATION OF SURPLUS AS REGARDS POLICYHOLDERS

For the Periods Ended December 31,

	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
Surplus as regards policyholders, January 1,	\$ 117,939,909	\$ 114,534,200	\$ 98,375,689	\$ 86,940,274
Net income	\$ 27,456,321	\$ 22,247,825	\$ 24,441,753	\$ 20,218,624
Net unrealized capital gains or (losses)	(2,975,489)	(10,831)	(249,047)	(1,900,899)
Change in net deferred income tax	540,074			
Change in non-admitted assets	(98,844)	13,138	110,474	(71,284)
Change in provision for reinsurance	(1,204)	2,100	(2,100)	
Change in excess of statutory reserves		(1,455,656)	(912,346)	(354,542)
Cumulative effect of changes in accounting principles	6,115,450			
Dividends to stockholders	(7,908,000)	(18,067,500)	(7,231,500)	(6,867,000)
Direct entries to surplus	166,371	106,749	32,147	84,644
Adjustment in prior year income tax liability	239,823	569,884	(30,869)	325,873
Rounding	(4)		(1)	(1)
Change in surplus as regards policyholders	\$ 23,534,498	\$ 3,405,709	\$ 16,158,511	\$ 11,435,415
Surplus as regards policyholders, December 31,	\$ 141,474,407	\$ 117,939,909	\$ 114,534,200	\$ 98,375,689

## **NOTES TO THE FINANCIAL STATEMENTS**

### **Note 1 – Losses**

**\$53,690,000**

#### **Loss Adjustment Expenses**

**\$ 9,346,000**

The amounts of the captioned liabilities are less than the amounts reported in the Company's 2001 Annual Statement. The Company reported \$55,668,268 as its liability for losses, which is \$1,978,268 more than the amount per examination. For loss adjustment expenses (LAE) the amount reported by the Company was \$13,455,516, which is \$4,109,516 more than the amount per examination. The total examination adjustment is \$6,087,784, which represents a material difference and has been reflected in the financial statements of this report. These examination adjustments were developed by the actuarial examiners, and were based on the following findings:

In the opinion of the actuarial examiners, the 2001 Annual Statement reserves were reasonably conservative given the information available at year-end 2001. However, the range of possible outcomes becomes narrower with the passage of time. Given actual development through year-end 2002, it is the opinion of the actuarial examiners that the 2001 Annual Statement reserves are outside the range of reasonable reserves. Therefore, adjustments are recommended for examination purposes. Consistent with the requirements for the statutory actuarial reserves opinion, the examination reserves must be within the range of reasonable reserves defined by the independent actuarial analyses of the actuarial examiners.

Company management explained that the approximate 85<sup>th</sup> percentile confidence level was targeted at year-end 2001, in order to book reserves at a conservative level. Company management stated that they wished to book reserves at a level where favorable development is more likely than adverse development. SSAP #55, paragraph 10 states that management shall record their best estimate of liabilities for unpaid losses and LAE. Upon detailed review of this guidance, it was determined that the NAIC did not intend this to be a strict guidance. It was determined that reasonably conservative reserve levels should not be specifically prohibited in the consideration of management's best estimate.

It was also the opinion of the actuarial examiners that the reserve redundancy was partially due to the data used to calculate defense and cost containment (DCC) reserves. Both the Company's actuary and the opining actuary relied upon an inconsistent mix of allocated loss adjustment expenses (ALAE) and DCC data in their respective reserve analyses. These actuaries were aware of the inconsistencies and attempted to judgmentally adjust their selections accordingly. In the opinion of the actuarial examiners, those adjustments were subjective. The results of the examination

reserve analyses, which used DCC-only data in the projection of DCC reserves, imply that the booked DCC reserves were conservative.

**Note 2 – Premium Deficiency Reserve**

**\$376,734**

The amount of the captioned liability is the same as reported in the Company's 2001 Annual Statement. The actuarial examination of this reserve determined that it was not necessary and that the amount per examination was \$-0-. The difference is not deemed to be material and no related change has been made in the financial statements of this report.

Premium deficiency reserves (PDR) in the aggregate amount of \$1,691,314 were calculated for the participants in the reinsurance pool. The aggregate PDR was allocated to each company based on the pooling percentages (including catastrophe-layer pooling) in effect at year-end 2001. The resulting PDR for the Company was \$376,734. See the report caption "Reinsurance" for details of the Company's participation in the reinsurance pool.

PDR liabilities are relatively rare for insurance companies writing standard personal lines insurance products. Since PDR is a relatively new item in statutory accounting, the Company's actuaries did not have significant historical guidance in establishing the PDR methodology. Therefore, they applied judgment, tempered with conservative assumptions to estimate PDR reserves. The actuarial examiners reviewed the assumptions and provided additional guidance relating to the PDR calculation. Some of the assumptions that contributed to the conservative results are briefly discussed as follows:

- The Company assumed that none of the other acquisition or general expenses are paid at or before policy inception. It is more common to assume that all of other acquisition expenses and a portion of general expenses are paid at or before policy inception.
- The PDR calculation incorporated discounting of losses and LAE for one-half of a year, whereas anticipated incurred losses could be discounted to the expected loss payment date. The discounting calculation assumed that all general expenses and other acquisition expenses are pre-paid. That assumption is inconsistent with the assumption listed above.
- The PDR calculation was conducted separately for each line of business for each direct book of business. The Company should have combined products that are marketed together and combined for profitability analysis. For instance, it is common to assume that auto liability and physical damage products are marketed on a combined basis.

The actuarial examiners conducted independent analyses of PDR, resulting in no indicated liability related to net unearned premiums as of year-end 2001.

**Note 3 – Unassigned Funds (surplus)****\$101,914,664**

The amount of unassigned funds per examination is \$6,087,784 more than the \$95,826,880 amount reported in the Company's 2001 Annual Statement. The following schedule presents a reconciliation of the amount of unassigned surplus reported by the Company with the amount developed by the examination, as of December 31, 2001.

Unassigned Funds reported by the Company		\$ 95,826,880
Examination Changes:		
Decrease in liability for Losses	\$ 1,978,268	
Decrease in liability for Loss Adjustment Expenses	<u>4,109,516</u>	
Total examination adjustments		<u>6,087,784</u>
Unassigned Funds per examination		<u>\$101,914,664</u>

**CONTINGENT LIABILITIES AND PENDING LITIGATION**

The examination for contingent liabilities and pending litigation included review of the Company's Annual Statement disclosures, minutes of the corporate governing bodies, pending claims, and the usual examination of the accounts for unrecorded items. No material unreported contingencies were noted and all litigation pending against the Company, at December 31, 2001, appeared to be within the ordinary course of its business.

The Company's Chief Executive Officer and its Chief Financial Officer executed a letter of representation, attesting to the non-existence of unreported liabilities and contingencies as of December 31, 2001.

**SUBSEQUENT EVENTS**

The review of events subsequent to December 31, 2001 and up to the date of this report included: review of the Company's 2002 Annual Statement; review of cash disbursements through December 31, 2002; review of corporate records through October of 2003; and, inquiries of Company management. No subsequent events were identified that were deemed to have an impact on this examination; and, no subsequent events were identified that might potentially have a material impact on the Company's continued operations and/or financial condition.

## **COMPLIANCE WITH PREVIOUS RECOMMENDATIONS**

It appeared that the Company had complied with all recommendations made as a result of the examination report as of December 31, 1997, except for the recommendation relating to fidelity bond coverage. See "Comments and Recommendations, Fidelity Bond and Other Insurance," which follows for the current recommendation.

## **COMMENTS AND RECOMMENDATIONS**

### **Holding Company and Affiliates – Agreements with Affiliates – Page 8**

It is recommended that the Company, and the affiliates with which it files consolidated federal income tax returns, develop a written tax allocation agreement, which specifies the terms for the settlement of intercompany balances, in compliance with SSAP No. 10, Section 12 c.

### **Management and Control – Conflict of Interest – Page 12**

The Company's conflict of interest policy was changed during the examination period, and subsequently amended to add the requirements of the Federal Sarbanes-Oxley Act. Annual reporting requirements have been eliminated under the new policy.

### **Fidelity Bond and Other Insurance – Page 13**

The Company's fidelity bond coverage was found inadequate to cover the twenty-two affiliates that are named insured on the policy. The Company has agreed to compute the required amount of coverage, based on a consolidation of the assets and income of all the named insured, and increase its coverage accordingly.

### **Market Conduct – Claims Payment Practices – Page 18**

The Company did not provide five claims files of a sample of forty-seven that were requested by the examiners. It is recommended that the Company keep complete and accurate records of its claims transactions, in compliance with Section 27-27-29(a), *Code of Alabama*, 1975.



### **Market Conduct – Complaints – Page 18**

It is recommended that the Company maintain a complaints register that includes all complaints received, rather than just those that are filed with regulatory agencies.

### **Losses & Loss Adjustment Expenses – Page 25**

The loss and LAE reserves reported in the Company's 2001 Annual Statement were found to meet the requirements of SSAP #55, at the time said reserves were reported. Nevertheless, based on development through year-end 2002, said reserves were not within a reasonable range. Reserves for losses and LAE have been adjusted in the financial statements of this report, by agreement between the examiners and the Company.

### **Premium Deficiency Reserve – Page 26**

The Company's PDR liability has been adjusted to zero for examination purposes. It is recommended that the Company re-evaluate its PDR calculations and assumptions for future analyses, and statutory reporting purposes.

## CONCLUSION

Acknowledgement is hereby made of the courtesy and cooperation extended by representatives of **Alfa Insurance Corporation** during this examination.

The customary examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and valuation of assets and the determination of liabilities set forth in this report.

Examination findings indicated that the Company was in sound financial condition as of December 31, 2001.

In addition to the undersigned, the following persons represented the Alabama Department of Insurance as participants in this examination: Palmer W. Nelson, AFE, Douglas T. Brown, Thomas W. Salo, Theophilos C. Goodin, Deanne Brown, Larae Mason and Bobby Mckinnon, examiners; Glenn Taylor, ACAS, MAAA, and Randall D. Ross, actuarial consultants.

Respectfully submitted,  
February 20, 2004



Rex H. Newborn, CFE  
Examiner-in-Charge  
Alabama Department of Insurance

**EXAMINER'S AFFIDAVIT AS TO STANDARDS AND PROCEDURES  
USED IN AN EXAMINATION**


**STATE OF ALABAMA**

**COUNTY OF MONTGOMERY**

Jack M. Brown, being duly sworn, states as follows:

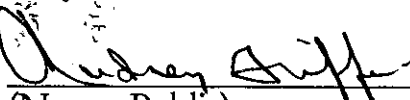
1. I have authority to represent the State of Alabama in the examination of Alfa Insurance Corporation, Montgomery, Alabama.
2. The Alabama Department of Insurance is accredited under the National Association of Insurance Commissioners Financial Regulation Accreditation Standards.
3. I have reviewed the examination workpapers and examination report, and the December 31, 2001 examination of Alfa Insurance Corporation, Montgomery, Alabama, was performed in a manner consistent with the standards and procedures required by the State of Alabama Department of Insurance, and the National Association of Insurance Commissioners.

The affiant says nothing further.

  
\_\_\_\_\_  
Jack M. Brown, CFE, CIE  
Assistant Chief Examiner, and Insurance Examinations Supervisor  
State of Alabama, Department of Insurance

Subscribed and sworn before me by Jack M. Brown, on this 16th day of July, 2004.

(SEAL)

  
\_\_\_\_\_  
(Notary Public)

My commission expires

(Date)

11/2/05